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Latin America: Challenging the IMF-Supported Adjustment Programs

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An Intelligence Assessment

Secret

ALA 85-10060
June 1985

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This paper was prepared by
contributions by

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Office of African and Latin American Analysis. It was coordinated with the Directorate of Operations.

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Comments and queries are welcome and may be directed to the Chief, South America Division, ALA,

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Key Judgments

Information available as of 8 May 1985 was used in this report.

Since the LDC debt crisis broke in 1982, most Latin American governments have adopted International Monetary Fund (IMF)–supported adjustment programs to reduce their external financing requirements. Their relationships with the Fund have been uneasy, however, and US embassies throughout the region report that these countries are becoming more troubled as the financing crisis persists. For example:

- Mexico's decision to speed economic recovery to make a strong showing in the July 1985 local and gubernatorial elections will probably mean the country will not be meeting most of its IMF targets later this year.
- Brazil's Sarney as well as Uruguay's Sanguinetti are publicly indicating that tough IMF austerity is unacceptable and that the Fund will need to become more realistic and flexible in designing programs.
- Argentina's President Alfonsin has been reluctant to comply with IMF-supported adjustments to avoid providing a rallying point for his political opponents.
- Peru's Belaunde has let IMF assistance lapse rather than implement tougher measures, which he views as socially destabilizing, while Alan Garcia, who will take power in Lima this July, has publicly called for bypassing the IMF to deal directly with international bankers.
- Bolivia's Siles and Colombia's Betancur refuse to implement IMF-supported stabilization programs, fearing the political consequences.

As internal concerns about the domestic political costs of adjustment programs mount, Latin leaders also face a growing demand from international bankers to comply vigorously with their Fund-supported programs. The IMF "seal of approval" is still required before government creditors and commercial banks will act on a debtor's request for financial assistance, [redacted] As 1985 wears on, we believe popular demands for more jobs, higher wages, better schools, improved health care, and the like will increasingly collide with stabilization requirements. The IMF-supported adjustment programs probably will be the battleground, with the risk that a confrontation will disrupt Latin America's ability to continue servicing its $84 billion debt owed to US banks.

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Beyond the immediate repayment risks, we believe that current Latin American negotiations with the IMF could also have a lasting impact on other important issues. In the economic area, these include creditors'

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willingness to provide financial support and US export and investment performance in the region. In political terms, building financial crises have the potential to undermine the debtors' ability to consolidate civilian rule, control narcotics trafficking, and subdue insurgencies. The economic difficulties of the states in the region may also open opportunities for the Soviets to expand commercial relationships.

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Contents

	Page
Key Judgments	iii
Scope Note	vii
Financial Rescue Programs Sputtering	1
Compliance With IMF Programs	1
Impact on Current Financial Packages	5
Challenges on the Horizon	6
Longer Run Financing Needs	6
Democratic Politics	7
Outlook and Implications for the United States	9

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Scope Note

This is one of several papers published or under way in the Directorate of Intelligence that examine the experiences of developing countries with IMF-supported adjustment programs. This paper deals with 10 Latin countries that have received the bulk of the attention of the international financial community since the LDC debt crisis emerged from Mexico and Brazil in 1982. The paper outlines the difficulty that most of these debtors have had complying with their negotiated IMF programs and the problems ahead for bankers and financial negotiators as the adjustment programs increasingly take on a political dimension.

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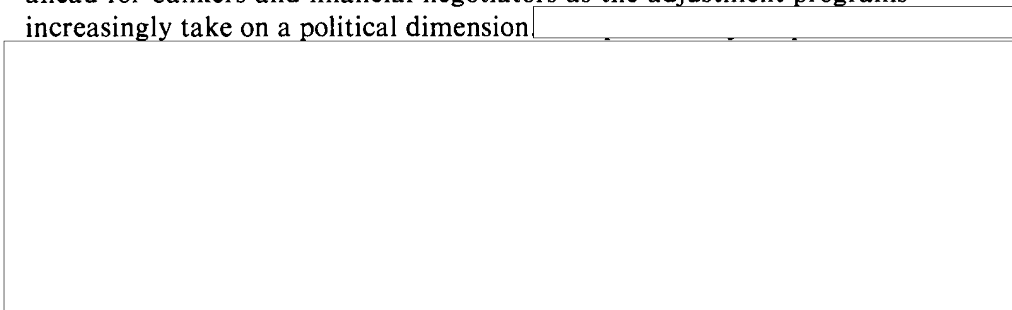

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Latin America: Challenging the IMF-Supported Adjustment Programs

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Financial Rescue Programs Sputtering

After a decade of heavy foreign borrowing, Latin American countries encountered severe difficulty in servicing their combined $240 billion foreign debt in 1982. Reduced export earnings, high world interest rates, and an abrupt cutback in bank lending after Mexico announced its payments moratorium caused serious financial strains for the region's largest borrowers. Major debt defaults were avoided, however, with a set of financial rescue packages coordinated by the International Monetary Fund (IMF). The Fund became the focal point for securing cooperation between private banks and Latin American governments in extending new medium-term loans and rescheduling maturing debts. By March 1983, Mexico, Brazil, Argentina, and Chile joined Peru in making IMF-supported adjustments. In June, Ecuador resolved its differences with the Fund and qualified for assistance.

Table 1 *Billion US $*
Latin America's Major Economies: Debt Currently Owed to US Banks [a]

Latin America	84.0
Brazil	23.6
Mexico	26.6
Argentina	8.2
Venezuela	11.0
Chile	6.7
Peru	2.4
Colombia	3.0
Ecuador	2.2
Bolivia	0.3

[a] Includes short- and medium-term loans owed by public- and private-sector borrowers to US banks.

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In our view, Latin American debtors' compliance with IMF programs is still the key to obtaining some $5-10 billion in new foreign financing and rescheduling $40 billion in payments in 1985.[1] According to US Embassy reporting most of the financial rescue programs are now being delayed in the face of the region's continued difficulty in meeting IMF performance criteria. Moreover, all signs point to difficulties between the major Latin American debtors and the IMF for some time to come.

Compliance With IMF Programs

The IMF suspended disbursements on *Brazil*'s 1985 program in February after a finding of noncompliance. According to press reports Brasilia exceeded the public-sector borrowing requirement and missed monetary control targets for December 1984, resulting in an inability to control inflation that official statistics report is about 230 percent at an annual rate. The new government's financial team quickly committed itself to getting the IMF program back on track, and soon after assuming office on 15 March it publicly announced new cuts in government spending, limits on federal lending, and a freeze on government hiring.

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Brazilian officials privately expect difficulties in negotiating fiscal, monetary, and inflation targets with the IMF in the months ahead. Sarney almost certainly will reassure the IMF that he supports stabilization in principle, but we believe he lacks the political will to implement a tough adjustment program to control inflation. Moreover, given his delicate political position and the widespread antagonism among Brazilians toward the IMF—an attitude reflected in recent public opinion polls—Sarney probably will not want to be perceived as acquiescing to harsh austerity

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IMF Conditionality and How It Works

A country making use of IMF resources is generally required to carry out an economic policy program aimed at achieving a balance-of-payments performance that its economy can sustain on its own. This requirement is known as conditionality. The point of conditionality is that balance-of-payments financing and adjustment of the underlying distortions that created the original payments problem go hand in hand. The Fund aims for the country to have a current account deficit that can be sustained by capital inflows on terms compatible with the development prospects of the country and without resort to restrictions on trade and payments.

Fund programs and performance criteria are designed jointly with the member country. The corrective strategy provides for reduction of balance-of-payments deficits and a reorientation of the economy toward sustained growth; it avoids purely deflationary policies that may have a deleterious effect on investment and that fail to encourage the required shift of resources to the external sector. Fund-supported programs emphasize a number of major economic variables, such as domestic credit (nearly all programs entail limits on credit expansion), public-sector financing, external debt, exchange rates, interest rates, and some commodity prices.

The financing available to members of the IMF through standby and extended fund arrangements is available in portions at specified intervals, and is drawn subject to meeting the agreed performance criteria. Any failure to observe the criteria prevents drawings until the Fund and the member examine whether further measures are necessary and they contract a new understanding on any needed changes in the program.

measures. Although Brasilia has yet to specify its negotiating position, we believe that a reconciliation will come, but only after several months of rancorous negotiations aimed at securing more lenient performance targets. Should the IMF insist to the end on rigorous austerity, we believe Brasilia may reconsider the advisability of a Fund-supported program.

The Fallout From Brazil's Abrogation of its 1962 IMF Agreement

Stagnant exports and a falloff in foreign investment led Brazil into a balance-of-payments crisis in 1961. The civilian Quadros government agreed to a $2 billion refinancing package in cooperation with the IMF, international bankers, and the US Government, but the succeeding Goulart administration did not follow through on promised economic stabilization measures. The IMF halted disbursement of standby credits in mid-1962 and Brasilia abrogated the accord, causing a cutoff of foreign funding.

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According to academic studies, Goulart was unable to implement austerity and comprehensive economic reforms in the face of civilian demands for sustained growth. Brazil's economic difficulties intensified throughout 1963—manifest in accelerating inflation, growing joblessness, and recurrent payment crises. Some academic sources contend that Brazil's worsening economy helped bring about the 1964 military takeover. Three months after assuming control, the military government of Castello Branco concluded an agreement with its creditors by implementing tough financial reforms.

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Mexico recently received approval from the IMF for the last phase of its three-year Extended Fund Facility, after almost six months of negotiations. Fund officials approved the 1985 program only after Mexico City announced substantial cuts in budgeted government spending. Some recent economic developments are already jeopardizing Mexico's ability to comply with its tougher commitments later this year. According to the US Embassy the government decided sometime in late 1984 that it must speed economic recovery even at the cost of rising prices and overvaluation of the exchange rate to make a strong showing in the July 1985 local and gubernatorial election. The US Embassy reports that the results of this decision are already being felt—public-sector spending pushed well above the target level

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during the first quarter, while the value of the peso was propped up by the administration. During January-March, the trade surplus eroded 40 percent to $2.4 billion.

The full economic impact of this year's election strategy will not be felt until late summer or early fall. By then we expect Mexico will not be meeting most of its IMF targets. The administration's spending spree will push the budget deficit far above target levels and will keep inflationary pressures high for the rest of the year. We project the increase in the cost of living will reach about 60 percent this year, far above the 45-percent goal. Mexico City's trade surplus will deteriorate even more with the growing overvaluation of the peso discouraging nonpetroleum exports and the soft world oil market cutting oil export earnings. Until the peso is adjusted, imports will rise with more rapid economic growth.

Weak trade performance combined with large interest payments on its foreign debt could cause Mexico to experience its first current account deficit since the financial crisis of 1982. Moreover, until the de la Madrid administration accelerates exchange rate devaluation, capital flight will remain a problem. Under these circumstances, Mexico will be forced to draw more from its foreign exchange reserves, rather than adding to reserves as called for in the IMF program. Mexico may also be forced to seek loans in international capital markets that exceed the IMF program limitations.

Argentina's IMF-supported program was suspended in mid-March after inflation—caused by growing budget deficits according to the local financial press—spiraled to an annual rate of 800 percent. New program targets are being renegotiated with the IMF, but Buenos Aires says it intends them to be "workable" targets. Recently, the US Embassy reported that Buenos Aires plans to raise taxes, signaling its willingness to implement austerity. The government has publicly indicated that more stringent measures to control inflation—monetary restraint and some budget tightening—will be implemented.

Regardless of Buenos Aires's intent, extended compliance with any Fund agreement will be difficult at best. Strikes—already occurring among private-sector workers and municipal employees—will probably become more frequent as wage increases are held below inflation. Military coup plotting also could become more serious, in part because of severe cutbacks in the armed forces budget. The parliamentary elections in November should spark even greater popular demands for improvements, especially as the economic slump causes unemployment to rise. With nearly all domestic political pressures pointing to less austerity, we expect another renegotiation for new IMF targets within a few months after concluding the revised agreement.

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Unlike Brazil, Mexico, and Argentina, most of the *Andean* debtors continue to shun IMF-supported adjustment programs because of the potential political fallout. For example:

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- *Colombia* is avoiding an IMF standby agreement for domestic political reasons, according to US Embassy reports, despite its growing need for foreign financing. Bogota prefers enacting some austerity measures on its own to avoid the perception of subservience to the Fund, but also hopes an IMF blessing of this approach will reopen access to foreign credits needed to develop export-oriented energy projects.

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- *Bolivia* holds infrequent discussions with the IMF for a standby program. The politically weak, lame-duck Siles government is unwilling to impose the tough austerity necessary for a Fund accord for fear of massive social unrest,

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- The IMF suspended *Peru*'s program last year, citing budgetary violations, and Belaunde refuses to take the tough steps to get the program back on track prior to the end of his presidential term in July.

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Moving against the trend of avoiding IMF-supported programs, the Fund approved *Ecuador*'s request for a new one-year, $103 million standby arrangement on 29 January. Quito had complied with its 1984 IMF

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Table 2
Status of IMF Programs and Compliance: Brazil, Mexico, Argentina, and Chile

	Most Recent Target	Performance
Brazil	[a]	
	Trillion Cruzeiros	
Public-sector borrowing requirement	67.8	Press reports indicate Brazil violated target by 10 percent.
Public-sector operational surplus	2.1	Press reports indicate public-sector deficit.
Net domestic assets of monetary authority	−50.0	Brazil violated target as monetary restraints loosened in December.
Monetary base	8.5	US Embassy reports Brazil expanded money base by nearly 28 percent in the fourth quarter.
Money supply	16.0	Brazil nearly doubled the targeted increase in money supply.
Mexico	[b]	
	Billion Mexican Pesos	
Net credits to the public sector by the Bank of Mexico [c]	3,958	Mexico is likely to violate target to finance the budget deficit.
Cumulative overall public-sector deficit [d]	430	Mexico is likely to just meet the target, but probably will miss more stringent targets later this year.
Cumulative changes in net domestic assets of the Bank of Mexico	127	Mexico is likely to miss the first-quarter target.
	Million US $	
Cumulative net foreign borrowing by the public sector [c]	500	Mexico will meet target.
Cumulative change in net international reserves of the Bank of Mexico [e]	1,000	Weakening current account and capital flight are likely to cause Mexico to barely meet target.

	Most Recent Target	Performance
Argentina	[a]	
Cash deficit of the nonfinancial public sector *(percent of GDP)*	8.7	Violated.
Net domestic assets of Central Bank *(billion pesos)*	884.5	Violated as monetary restraints loosened.
Net international reserves *(billion US $)*	8.85	Missed target by $600 million.
Limit on outstanding external payments arrears *(billion US $)*	2.6	Argentina is failing to stay current on payments.
Consumer inflation [f] *(percent change)*	300	Target cannot be attained; inflation now 850 percent.
Current account deficit *(billion US $)*	2.2	Probably violated target by $500 million in 1984.
Chile	[g]	
	Billion US $ (except where noted)	
Current account deficit	1.38	Chile likely to miss target as trade surplus remains depressed.
Gross international reserves	2.00	Chile has already drawn down $380 million through February, according to US Embassy.
Public-sector deficit *(percent of GDP)*	3.5	Chile likely to violate target as government increases assistance for earthquake reconstruction.
Inflation *(percent change, Dec/Dec)*	25.0	Inflation is running at a 35-percent annual rate through February.

[a] Targets set for fourth quarter 1984.
[b] Targets set for first quarter 1985.
[c] Adjusted.
[d] Limit tested at end of each period.
[e] Amount subject to ceiling is defined as the difference between note issue and net foreign assets.
[f] September 1985/September 1984.
[g] Targets set for calendar year 1985.

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The Financial Pitfalls of Bypassing the IMF: The Case of Peru

A fall in copper prices and anchovy exports plus increased oil and military imports led the Peruvians toward greater foreign borrowing in the mid-1970s. In 1976, commercial banks agreed to roll over Peru's debt contingent upon enactment of a stabilization program designed by the lenders. Lima initially fulfilled its commitments and the banks released $400 million in loans, but in early 1977 government spending far exceeded the program limits set. Banks refused additional loans without IMF participation.

Through July, Peru and the IMF negotiated for a formal program, but violent strikes and riots caused by cuts in food and fuel subsidies led the government to break off its IMF discussions. Peru then tried to bypass the Fund and deal directly with its creditors, but without the ability to monitor and enforce policy adjustments. Bankers insisted that Lima conclude an IMF agreement, and such an accord was signed in November 1977. The government met its quantitative targets only for a three-week period and the Fund again declared Peru out of compliance in early 1978, causing banks to suspend rollovers.

program requirements, and the new government is seeking to strengthen Ecuador's external position and reduce inflation by working with the IMF. It has agreed to tougher limits on external borrowing, credit creation, and public-sector spending, according to Fund reports.

Chile reached preliminary agreement with the IMF on 15 February for a three-year, $750 million Extended Fund Facility. According to US Embassy reports, the 1985 program targets include limits on public-sector borrowing and the deficit, a slight increase in international reserves, and a 30-percent reduction in the current account deficit to $1.4 billion. According to press reports, Chile's new Finance Minister, Hernan Buchi, has asked for greater flexibility in meeting performance targets; for its part, the IMF has agreed to raise the budget deficit target to 3.5 percent of GDP to permit public spending for reconstruction of extensive earthquake damage that occurred earlier this year.

Although Chile is publicly committed to its IMF agreement, we believe that reconstruction of damage from the March earthquake will impede compliance with the program's domestic targets. The earthquake, which Santiago claims caused an estimated $1.8 billion in damage to homes, schools, roads, and ports, will probably result in a growing budget deficit and will increase the current account deficit by well over $300 million in excess of the IMF target. US Embassy reporting indicates that exports of two major foreign exchange earners—copper and fruit—will remain at the same depressed levels as last year, while Santiago will be hard pressed to reduce imports by the targeted 13.2 percent if it is to help in postearthquake reconstruction. Further, US Embassy reports indicate spot shortages from the earthquake will push the cost of living beyond the 25-percent inflation target.

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Compounding strains on the IMF-supported program this year will be banker unwillingness to meet Chile's request for new foreign funding. According to US Embassy reporting, Chile's debt negotiations are at an impasse over Santiago's request for $1 billion in new loans in 1985, while bankers remain adamant they will provide only $500-700 million. Because of these difficulties, we believe the economic team will be forced to draw down Chile's foreign exchange reserves to meet debt servicing obligations, despite its pledges to the IMF to keep reserves at the December 1984 level of $2.0 billion. In our opinion, Santiago will seek waivers on every IMF target and threaten suspension of its debt payment if creditors are not accommodating.

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Impact on Current Financial Packages

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Foreign bankers have reacted to the spate of noncompliance with Fund-supported programs by delaying rescheduling agreements and new loans for those Latin American debtors having difficulties meeting IMF-backed adjustment programs. Bankers had postponed for six months the formal conclusion of *Mexico*'s $49 billion debt restructuring program until the IMF approved a revised stabilization program in March, according to the financial press. Upon announcement that the IMF suspended talks with *Brazil* earlier this year, its bank advisory committee—which had reached tentative agreement on the terms of a

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multiyear rescheduling agreement covering some $45 billion in debt—and the Paris Club halted their respective debt negotiations, pending a new agreement between Brazil and the IMF. *Argentina*'s bank creditors are withholding the first $2 billion disbursement of the $4.2 billion loan package signed last December when the IMF suspended a $230 million payment, according to a Fund statement. Buenos Aires was unable to obtain an emergency bridge loan to repay overdue interest. Instead, it made a $50 million payment toward public-sector interest arrearages to prevent US regulators from downgrading Argentine loans, according to the press.

The large Latin debtors are not the only ones facing difficulties with international bankers. According to US Embassy reporting, bankers are still reluctant to grant *Colombia*'s request for $800 million in new funds until Bogota obtains an IMF agreement to monitor its self-imposed adjustment program. Financial assistance packages for *Peru* and *Bolivia* remain stalled over their unwillingness to negotiate with the IMF and clear interest arrears.

While bankers are reluctant to put themselves further at risk in such countries, they are apparently still willing to consider financial assistance for Latin American countries that are accepting Fund-supported programs. *Ecuador*'s financial rescue package—which includes $200 million in new money and the rescheduling of $4.3 billion—is nearing completion, according to the financial press. *Chile*'s preliminary IMF agreement in February helped lead to the resumption of rescheduling talks in mid-March. Although bankers are resisting Santiago's $1 billion new money request, US Embassy reporting indicates that the Chileans will probably receive between $500 million and $700 million in new bank loans.

Challenges on the Horizon

In looking ahead, we see some fundamental changes in Latin America that will affect the financial situation. One of the critical challenges facing Latin debtors is balancing longer run international financial requirements against the immediate internal needs of being responsive to the electorate in emerging democratic systems. With the inaugurations of civilian presidents in Brazil and Uruguay last March, there are now nine civilian governments at the helm of financial rescue programs. Although we judge that these leaders recognize the necessity of economic stabilization to maintain creditor cooperation and to foster recovery, they are now taking a tougher stand on the politically risky aspects of the IMF's recommendations. Since the Cartagena, Colombia, meeting last June, the newly installed governments have begun to take a more political approach to economic problems, a factor that will probably complicate the management of their financial rescue programs in the future.

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Longer Run Financing Needs

The objective of the IMF programs has been to assist countries to attain a viable balance-of-payments position through policies that reduce or eliminate the economic distortions that in part caused the payments difficulties in the first place. The adjustment programs usually involve currency devaluations, tax reform, stricter budget controls, reductions in the scope of government enterprises, and development of a more market-oriented environment to bring demand for foreign funds into line with international bankers' willingness to lend.

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The likelihood of difficulties in complying with IMF programs portends that progress in resolving debt problems and toward stronger long-term economic growth will be slow in Latin America. We believe those debtors who repeatedly fall short of their targets will suffer disruptions of loan disbursements and delays in obtaining debt rescheduling necessary to lessen debt constraints. As it is, we estimate that Latin America's current account deficit could potentially triple to about $6 billion in 1985. On the basis of bankers' reactions to date, we judge it highly unlikely that bank financing will be available to cover such a deficit, and almost certainly would not be voluntary in the absence of an IMF-supported program. Looking ahead, most US econometric forecasting services project that major Latin American debtors' current account deficits will persist in the $6-10 billion range

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through the end of the decade. New external shocks—such as slower OECD growth, increased interest rates, and lower commodity prices—would only make the payments strains of the region that much more difficult.

As far as economic growth is concerned, Latin America faces weak economic prospects through the decade. Many commercial and academic forecasters expect the region to grow at an annual average rate of 3 percent through 1989 with only a slight reduction in inflation. They base this dismal outlook on the lack of new development financing and continued import restraints. We believe that patchwork reforms will also leave serious budget deficits to fuel the region's average 140-percent inflation rate for the foreseeable future. If inflation stays in this range, we believe it will continue to undermine capital formation and discourage the repatriation of capital needed to bolster domestic investment. We also believe growing economic uncertainty will make Latin American efforts to attract new foreign direct investment more difficult.

Against this economic setting there is always the chance that one or two key debtors may seriously consider breaking with IMF-supported programs in an attempt to revive their economies through populist policies, such as deficit spending, large wage increases, and rapid monetary expansion. We believe that if a break occurred the cessation of new lending and possible debtor default that would follow would markedly hurt Latin growth prospects. A recent academic study concludes, for example, that the forced import cutback that would follow a default would reduce Latin American output by over 6 percent in the first year—an economic plunge twice as severe as Latin America's 1983 recession, the worst on record. According to this study, Latin America probably would follow a lower growth path for a decade because foreign exchange scarcities would reduce imports while the cessation of voluntary lending would undercut new investment in productive capacity.

Democratic Politics

Regardless of the economic realities, US Embassy and press reports indicate that there are growing popular demands throughout the region for improved living standards. According to the Economic Commission for Latin America, real per capita income in Latin America has fallen back to levels of the late 1970s in the wake of global recession and the ongoing austerity programs implemented to resolve debt difficulties. The new civilian authorities in Argentina, Brazil, and Uruguay, elected on promises of change and improvement, must demonstrate economic progress or face challenges to their rule. New leaders scheduled to take over this summer in Peru and Bolivia will have similar prospects. We believe most of these governments probably will be tempted to stimulate short-term growth to expand employment and business activity, despite the adverse impact such forced growth would have on inflation and their external finances.

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The implementation of stabilization programs, in our opinion, will be more difficult as these new leaders try to balance the conflicting demands of key interest groups. At the least, we believe the civilians will increasingly press the IMF to ease its conditionality requirements:

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- *Labor unions* in Argentina, Bolivia, Brazil, Peru, Uruguay, and Venezuela are becoming strident in demanding higher wages, according to a review of press and US Embassy reporting.
- *Business* is seeking wage restraints, price hikes, import protection, and growth policies aimed at absorbing idle capacity, according to US embassies in the region.
- *Legislatures* will probably become more involved in financial matters—Brazil's Congress has already served notice that it intends to scrutinize new debt agreements, according to the US Embassy.
- *Leftists,* such as the radical factions in the governing parties in Argentina, Brazil, and Peru, are advocating repudiation of the foreign debt to restore social spending and accelerate growth,

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Prospects for the Cartagena Debtors' Group

Eleven Latin American debtor countries—known now as the Cartagena Group—met in late June 1984 in Cartagena, Colombia, to discuss debt and trade problems facing the region. Although bankers worried about the formation of a Latin debtors' cartel, the region's key decisionmakers refrained from radical action. most Latin leaders recognized that collective action to force easier repayment terms would only jeopardize their access to foreign funds as well as their individual efforts to negotiate debt restructuring agreements with creditors. With the largest debtors—Brazil, Mexico, Argentina, and Venezuela—willing to deal individually with creditors, the Cartagena Group has subsequently become a less potent political force.

Despite several followup meetings, US Embassy and press reporting indicate that support for unified regional action against creditors is still marginal. At its February 1985 meeting in Santo Domingo, the Cartagena Group again resisted radical proposals, such as tying debt service to exports or capitalizing interest payments. Instead, Latin Americans called for increased financing on easier terms through existing multilateral channels and for a political dialogue with creditor countries. In April, the Cartagena Group renewed its call for the participants at the Bonn summit meeting to enter into a political dialogue on the debt issue. According to the communique issued at the meeting, the Cartagena countries made a plea for understanding, stating cooperative action by the industrial countries would help alleviate Latin external debt burdens and preserve democracy in the region. Although the goals of the political dialogue were not well articulated, the debtors were in agreement that international trade and monetary reforms were needed to assure growth.

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we judge that the Cartagena Group, given the present degree of disunity among its members, is unlikely to form a debtors' cartel over the near term. The group will probably continue to support positions that do not interfere with bilateral debt renegotiation. We also believe, however, that, if Latin debtors see little financial relief in sight, the group would be increasingly inclined over the longer term—individually as well as collectively—to step up pressure. Creditor banks and developed country governments could face demands to share the adjustment burden by granting easier repayment terms and trade concessions.

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Under these conditions, we believe a severe deterioration of relations between Latin debtors and bankers could follow. In the absence of organized collective action, we speculate that a small country—or group of countries like Peru and Bolivia—could publicly refuse to pay any of its debt because of domestic strife caused by austerity. Such a situation could conceivably spread, in a domino effect, to a larger debtor, such as Argentina. In a variation on this theme, the smaller debtors would quietly suspend payments and receive the tacit support of the larger debtors in hopes of benefiting from any concessions granted by creditors to the smaller debtors. Finally, we can also envision a spontaneous debtors' rebellion breaking out whereby most of the Cartagena countries withhold debt repayments as their debt negotiations individually reach an impasse with creditors.

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- *Military* leaders, watching these political moves closely in the event they need to intervene to quell unrest, are seeking to restore appropriations affected by budget cuts.[2]

The adverse reaction to economic adjustment is not split cleanly along partisan lines. The politically important Latin American middle class—which spans the political spectrum—is also demonstrating concern

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Bankers' Response to Latin Debt Difficulties

International bankers as a group appear to be having difficulty responding to Latin America's continuing debt difficulties. [redacted] *creditors are concerned about the ability of Latin governments to hew to austerity needed to stabilize their economies and strengthen their payments position. Bankers are continuing to insist that the IMF exercise a role in overseeing economic adjustment programs even for countries that do not require temporary balance-of-payments support. For example, Brazil's multiyear rescheduling is contingent on a new IMF agreement, even though the country is running a near-balanced current account and has increased international reserves.* [redacted]

Banker cohesiveness, however, wanes when debtors request additional lending. Growing uncertainty among some bankers about the efficacy of Latin stabilization programs is translating into increasing difficulty in assembling new loans, especially for Argentina, Chile, and Peru. [redacted] *the largest lenders are still willing to increase their exposure, numerous smaller lenders are refusing to participate in these credits. Smaller US and European banks, according to financial press* [redacted] *are also willing to consider alternatives to providing new money, such as interest capitalization schemes and limits on interest payments as a share of export earnings. More worrisome, the smaller lenders are still also inclined to reduce their exposure to the region,* [redacted] *preferring to write off their debts, sell them at a discount, or reduce trade credits.* [redacted] *smaller lenders cut trade lines to Peru earlier this year following President-elect Alan Garcia's public threat to bypass the IMF. Under such conditions, we judge that financial assistance in support of Latin America's economic adjustment will increasingly fall to the major international banks.* [redacted]

[redacted] *the larger creditors recognize that resolving Latin debt problems will require both time and patience. They continue to approach debt problems pragmatically on a case-by-case basis, and still demand a credible stabilization program for strengthening the balance of payments in return for financial assistance. Recently, however, the larger creditors have shown a willingness—manifest in the recommendations of bank advisory committees that they control—to accept other than a formal IMF-supported adjustment program. In September 1984, for example, the bank advisory committee agreed in principle to grant Venezuela a multiyear debt rescheduling on easier terms as long as Caracas continued its self-imposed stabilization program and cleared up past due debts. This year, Colombia's bank advisory committee agreed to a new money and debt rescheduling package in support of an internal stabilization program that would simply be "monitored" by the IMF.* [redacted]

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[redacted] *larger creditors are cognizant of rising demands throughout Latin America for more rapid growth. As a result, the creditors are now agreeing to multiyear rescheduling agreements on easier terms for debtors making a "good-faith" adjustment effort. For example, Mexico and Ecuador have recently been formally granted multiyear rescheduling in support of their adjustment programs. Similarly, the larger creditors are also calling on the World Bank group to complement these efforts by providing new credits and guarantees in support of long-run structural adjustment.* [redacted]

The larger creditors operate under varying regulatory constraints that limit their collective ability to adapt to debtors' problems and demands. Even so, [redacted] *some of these creditors are experimenting with innovative forms of debt relief. According to press reports, financially troubled Peru has already convinced Soviet and some European creditors to accept barter goods instead of money as payments for debts.* [redacted] *some US large banks may be willing to provide such export marketing assistance to Peru and Bolivia. Recently, Chile's bank advisory committee has agreed to change the timing of interest payments—thus far interest payment schedules have been sacrosanct—in an effort to provide additional foreign exchange savings. At this juncture, however, the larger lenders continue to shy away from implementing bold financial reforms, such as sharply reduced interest rates or interest capitalization schemes, proposed by major debtors for resolving Latin America's financial problems.* [redacted]

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about the advisability of IMF-recommended adjustments. According to recent United States Information Agency public opinion surveys in Brazil, Colombia, Costa Rica, and Venezuela, most of the adjustment policies traditionally negotiated with the IMF—such as wage restraints, price increases, and devaluation—are seen as harmful measures by majorities in each of these countries. Moreover, these surveys reveal that in Brazil over half of those polled considered agreements with the IMF as a harmful policy option; in the other countries respondents viewed IMF programs as generally more harmful than helpful. Instead, according to these polls, import restrictions and the formation of a Latin debtors' group are chosen—by large minorities to small majorities—as the most helpful measures in dealing with the debt crisis.

Outlook and Implications for the United States

Against this backdrop of economic and political challenges, we judge that most Latin American debtors will agree to live with some kind of IMF-supported adjustment programs to obtain debt rescheduling, new money commitments, and other bilateral and multilateral assistance. We believe, however, that most Latin American nations will probably fall out of compliance with their programs, and that the IMF and debtor governments will find it necessary to revise the terms of these programs more frequently. Thus, we expect these countries' relations with the IMF to become more contentious as political considerations are increasingly injected into technical negotiations.

With the IMF-supported adjustment programs entering this phase, we believe Latin debtors will expect Washington to play an increasingly active role in keeping financial rescue on track. As 1985 wears on, we believe that Latin debtors will press US officials to:

- Intervene in disputes with the Fund to soften conditionality, thus seeking to balance the requirements of economic stabilization against the political imperatives of democracy.
- Nudge lenders to provide credit and debt rescheduling and help design financial strategies that support economic recovery.

We judge that some Latin American debtors may look favorably on recent US efforts to assist countries complying with IMF-supported programs. They may see such initiatives as selective multiyear reschedulings of official debt in Ecuador, willingness to provide expanded export financing facilities to Brazil, and new investment insurance guarantees to Ecuador as tangible moves to exert subtle pressure on creditors toward more flexible and innovative financial arrangements.

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For the longer run, we judge that continuing uncertainty surrounding Latin America's external financial situation will affect US strategic interests in a number of areas:

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- Economic discontent will contribute to social restiveness and could heighten the popular appeal of more radical leaders, such as Leonel Brizola in Brazil, enabling leftist-leaning candidates to be brought to office through the ballot box.
- Declines in living standards will provide incentives for increased narcotics production and trafficking, which will further challenge US-sponsored eradication efforts.
- Budgeting stringencies will impede the ability of governments to control insurgencies and limit funds available for pacification programs.
- Continued financial turmoil will provide new, albeit limited, opportunities for the Soviets to expand commercial ties.
- Persistent debt repayment problems will cause the Latin countries to eye periodically the formation of a debtors' cartel.

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Regardless of how events unfold, we believe that US–Latin American economic relations will remain troubled for the foreseeable future and as such will be a factor that must be weighed in the full range of bilateral dealings for at least a number of years to come.

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